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SUBJECT: CYPRUS GETS FINAL APPROVAL TO ADOPT EURO JANUARY 1, 2008

REF: A) NICOSIA 498 B) NICOSIA 439 C) NICOSIA 247

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(U) This cable is sensitive but unclassified. Please treat accordingly.

¶1. (SBU) Summary. As expected, EU finance ministers formally invited Cyprus (and Malta) to adopt the Euro on January 1, 2008, during the July 10 ECOFIN meeting in Brussels. The EU finance ministers also set the final rate at which the Cypriot pound will be exchanged into Euro at one Euro equals CYP 0.585274 (or roughly one Cypriot pound equals 1.71 Euros). This is the same rate at which the Cypriot pound joined the Exchange Rate Mechanism II in May 2005, and at which the GoC unilaterally pegged the Cypriot pound to the European Currency Unit (ECU) in 1992. Cyprus and Malta will become the fourteenth and fifteenth EU member states to adopt the Euro but will add only around 1.2 million people to the current Eurozone population of 318 million and will increase the Eurozone's GDP by only 0.2 percent. Adoption of the Euro will apply only to the government controlled area of Cyprus. The area administered by Turkish Cypriots will continue to use the Turkish Lira as its legal currency. For more information on the GoC's changeover plans and possible effects of Euro adoption, please see reftels. End summary.

¶2. (U) Cyprus cleared the final hurdle toward Euro adoption July 10 when, as widely expected, EU finance ministers formally invited the Government of Cyprus to adopt the Euro on January 1, 2008. The finance ministers also set the final rate at which the Cypriot pound will be exchanged into Euro at the same rate at which the Cypriot pound entered the ERM II on May 2, 2005. This rate of one Euro equaling CYP 0.585274 (or one Cypriot pound equaling 1.7086014 Euros) means a slight depreciation of the Cypriot pound vis-a-vis the Euro of roughly 0.2 percent from the rate at which it was trading on July 8. After entering the ERM II on May 2, 2005, the pound quickly appreciated, peaking at CYP 0.5729 per Euro in September 2005 (or 2.1 percent above the central parity rate), after which it slowly depreciated against the Euro, ending up just above the central parity rate this summer.

¶3. (SBU) Finance Minister Michalis Sarris welcomed ECOFIN's invitation calling "the forthcoming adoption of the Euro a milestone in the history of the Republic of Cyprus." The goal of Euro adoption has already contributed to the growth of the Cypriot

economy by forcing the GoC to introduce fiscal discipline and sound economic policies. Real GDP has grown roughly 3.8 percent per year since 2004. Long-term interest rates have fallen 330 basis points in the past five years, while mortgage rates have fallen 160 basis points. Inflation has dropped from 4 percent in 2003 to roughly two percent today.

¶4. (SBU) Adoption of the Euro is also expected to continue to spur Cypriot growth by locking Cyprus in to the Eurozone's historic low inflation and interest rates, reducing currency transaction costs and exchange rate risk, increasing competition through greater price transparency, and providing easier access to a large, liquid, capital market. While Cyprus will be giving up its ability to pursue independent monetary and exchange rate policies, Central Bank officials believe this is not much of a sacrifice. The GoC never used the latter; the EU is Cyprus's main trading partner; and Cypriot business cycles are largely synchronized with those of the larger EU states. Nevertheless, a recent poll showed only 38 percent of Cypriots believed that adoption of the Euro would have any positive effects for Cyprus, while most Cypriots (83 Percent) believed it would lead to unjustified price increases.

¶5. (SBU) The GoC plans to introduce a number of programs to address the fear of unjustified price hikes. For instance, the GoC is establishing special "Euro Observatories" to monitor price levels in stores, has established significant fines for those found taking advantage of the currency changeover to "cheat" customers (up to 170,000 Euros), and plans to "name and shame" offenders. It is also introducing a voluntary system under which businesses that comply with a set of "fair pricing" guidelines will be able to display special logos. Several businesses, including Cyprus's largest retailer, have also unilaterally announced plans to reduce prices on January 1 by around one percent.

¶6. (SBU) Nevertheless, some observers warn that retailers traditionally raise prices on January 1 to reflect Cyprus's two percent inflation rate and fear that Cypriots may attribute justified price increases to the Euro changeover. Furthermore, EU-mandated increases in the VAT rate for certain foods and medicines that are required to go into effect January 1 are by themselves expected to increase the price level a further one percent. To help Cypriots avoid mistakenly conflating the effects of these increases with adoption of the Euro, the GoC has asked the EU for permission to delay the tax increase until July 1. Nevertheless, critics warn that any price increases in the first half of 2008 are likely to be attributed to adoption of the Euro and could undermine Cypriot support for the island's new currency. The success or failure of the introduction of the Euro could have political consequences given that presidential elections are scheduled for February 2008.

¶7. (SBU) The GoC also announced plans to further intensify its much-maligned Euro information campaign and to require dual pricing as of September 1. Some businesses have already begun showing prices in both Cypriot pounds and Euro, and the Organization of Industrialists and Entrepreneurs is encouraging all its members to begin dual pricing immediately. The GoC plans to allow dual circulation of the two currencies from January 1, 2008 to January 31, 2008 only, during which all business will be required to give change in Euro. Banks, however, will exchange Cypriot pounds for Euros until June 30, 2008, while the Central Bank will exchange Cypriot coins until December 31, 2009, and Cypriot bank notes until December 31, 2017.

¶8. (SBU) While on January 1 the Euro will become the official currency in the government controlled area of Cyprus, the area administered by Turkish Cypriots will continue to use the Turkish Lira as its legal currency. Nevertheless, the GoC's adoption of the Euro should remove the contentious issue of which currency a future united Cyprus should use. A united Cyprus in the EU will be required under EU rules to use the Euro, an outcome that seems acceptable to both sides.